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Tax Guide for U.S. Citizens Employed in U.S. Possessions

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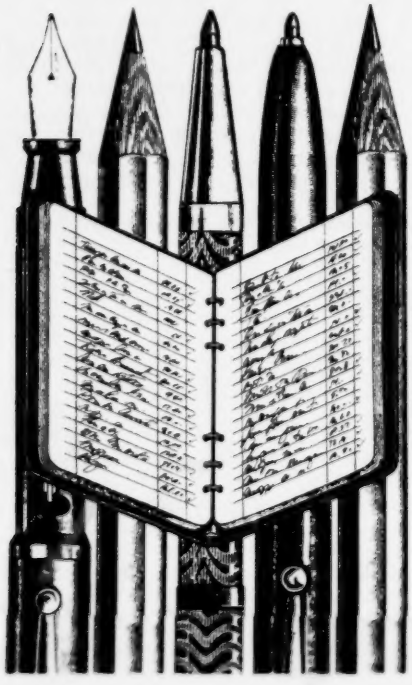
For use in preparing
1980 Returns



Introduction

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A U.S. citizen by birth or naturalization, who works as an employee or operates a business in a possession of the United States may qualify for the possession exemption.

The possession exemption allows an individual U.S. citizen to exclude from gross income amounts received from sources outside the United States if in a 3-year or other applicable period immediately before the end of the tax year:

1) At least 80% of gross income is from sources within a U.S. possession, and
2) At least 50% of gross income is from the active conduct of a trade or business within a U.S. possession.

Use of the term "trade or business" throughout this publication refers to the active conduct or operation of a trade or business, either on your own account or as an employee or agent.

Aliens and U.S. citizens of possessions who hold their U.S. citizenship under an Organic Act do not qualify for the exemption. If you are in either status and work in a possession, you may request tax advice from the Office of International Operations, Internal Revenue Service, Washington, D.C. 20225.

The possession exemption does not apply to all taxpayers; and it may not be advantageous for those to whom it does apply. Even if you qualify for the possession exemption, you do not have to claim it. You should figure your tax both ways to see which is better for you.

If you have specific questions about income earned in a U.S. possession, refer to the Index at the end of this publication. Guam, the Northern Mariana Islands, American Samoa, the Commonwealth of Puerto Rico, and the Virgin Islands have their own independent tax systems. Information about filing returns with the local tax authorities of those islands is given later.

The terms "gross income" and "wages and salaries," for the purposes of this publication, include the gross income of persons who are actively engaged in a trade or business, as well as of employees.

The exemption rules for U.S. citizens employed in U.S. possessions are different from those for U.S. citizens in foreign countries.

U.S. citizens who cannot meet the possession-exemption rules but who receive earned income from sources within U.S. possessions may qualify for benefits relating to earned income from sources outside the United States if they are bona fide residents of, or are physically present for a specified period in, a foreign country. For these citizens, none of the rules about income from U.S. possessions applies in determining their tax liabilities. For information about the deduction for excess foreign living costs or the exemption of income for U.S. citizens in foreign countries, see Publication 54, *Tax Guide for U.S. Citizens Abroad*.

U.S. corporations do not qualify for the possession exemption for tax years beginning after 1975. However, under certain conditions they may elect to claim a tax credit. The amount of the credit equals that part of the U.S. tax liability that is based on taxable income from sources outside the United States from the active conduct of a trade or business in a possession or qualified possession source investment income. For additional information, see Form 5712, *Election to be Treated as a Possessions Corporation Under Section 936*, and Form 5735, *Computation of Possessions Corporation Tax Credit Under Section 936*.

Government and Military Personnel

Wages, salaries, and other kinds of pay from the U.S. Government to civilian and military employees are subject to the U.S. federal income tax. That income may not be treated as exempt income under the possession-exemption rules explained in this publication.

If you are a U.S. Government employee in a possession and you also work for a private employer, the wages received from the private employer are also likely to be subject to the federal tax because you may be unable to meet the 80% and 50% possession-exemption rules, discussed next.

Possession Exemption

If you are employed in the following areas, you may be able to qualify for the possession-exemption of income:

Midway

Palmyra

Johnston Island

Kingman Reef

Wake Island

Howland Island

Baker Island

Jarvis Island

American Samoa and

Other U.S. islands, cays, and reefs that are not part of any of the 50 states.

The former ***Panama Canal Zone*** is no longer a U.S. possession for tax purposes and U.S. taxpayers residing there will be considered to reside in Panama. These individuals are subject to U.S. tax in the same manner as U.S. taxpayers in any foreign country. See Publication 54, *Tax Guide for U.S. Citizens Abroad*, for more information.

A military base leased by the United States from a foreign government is not a possession of the United States for purposes of the possession exemption.

The possession-exemption rules do not apply to the Marshall Islands. These islands are administered under the trusteeship agreement between the United States and the Security Council of the United Nations.

If you are employed in Guam, the Northern Mariana Islands, the Virgin Islands, or Puerto

Rico, you do not qualify for the possession exemption.

Qualifications

Two requirements must be met concerning income received during your ***applicable period***:

1) ***80%*** or more of the total gross income must be from sources in a possession, ***and***
2) ***50%*** or more of the total gross income must consist of wages, salaries, and other compensation for personal services performed in a possession, and from the active conduct of a trade or business in a possession.

The key factor is that the percentage rules apply to income received during your ***applicable period,*** not during your tax year.

Applicable period. You must know your applicable period to determine if you qualify for exemption of income that you earned in a possession. The applicable period must be entered on Form 4563, *Exclusion of Income from Sources in United States Possessions.* See *Filing Tax Returns,* later, for information on how to fill out that form.

Your applicable computation period is the period that you were employed or engaged in business in a possession before the end of your tax year. It is also the period that falls within the 3-year period immediately before the end of your tax year.

The following examples illustrate the applicable periods of taxpayers preparing their 1980 federal income tax returns.

Example 1. Anna Grey worked in a possession from January 1, 1978, to November 15, 1980. Her applicable period for 1980 is January 1, 1978, to November 15, 1980. The period falls within the 3-year period immediately before December 31, 1980, which is the end of her 1980 tax year.

Example 2. Bill White started working in a possession on March 14, 1980. He was still there on April 1, 1981, when he prepared his 1980 tax return. His applicable period for 1980 is March 14, 1980, to December 31, 1980.

Example 3. Charles Black worked in a possession from July 1, 1969, to February 18, 1981. His applicable period for 1980 is January 1, 1978, through December 31, 1980.

Example 4. Gloria Brown worked in a possession from January 17, 1980, to October 15, 1980, when she left the possession. Her applicable period for 1980 is January 17, 1980, to October 15, 1980.

Example 5. Edward Greene started working in a possession for X Company on March 2, 1979. He ended that employment on August 27, 1980. On September 5, 1980, Edward took employment in a possession with Z Company and has remained with them. Edward's applicable period for 1980 is March 2, 1979, to August 27, 1980, and September 5, 1980, to December 31, 1980.

The fact that Edward worked for two different companies and that he had separate periods of employment does not affect his eligibility.

Sources of income. The source of income is important. For the 80% rule, you must know if your income is from sources in the United States, a possession, or a foreign country.

General rules for determining the source of income are given below. If you cannot clearly determine the source of your income, you should write to the Office of International Operations, Internal Revenue Service, Washington, D.C. 20225, for assistance.

Income from sources within a possession includes:

1) Wages, salaries, and other kinds of compensation for personal services performed in a possession. However, U.S. Government wages, salaries, and military pay, or pay from any U.S. agency, is income from U.S. sources.
2) Dividends received from possession sources, including those paid by:
   a) U.S. corporations that do business in a possession and elect the Puerto Rico and possession tax credit, and
   b) Possession and foreign corporations that do business primarily in a possession.
3) Interest on deposits paid by banks that do business mainly in a possession. This includes interest paid on deposits with the possession branches of:
   a) Domestic banks with commercial banking business in the possession, and
   b) Savings and loan associations chartered under federal or state laws.
4) Gains from the sale of securities, such as stock certificates within a possession.

Income from sources outside a possession includes:

1) Wages, salaries, and other kinds of compensation paid for personal services performed outside a possession. The source of such wages, salaries, etc., is the place where the services were performed even though payment is made in the possession. (See the exception, below.)
2) Dividends paid by corporations ***not*** doing business in a possession. Dividends paid by U.S. corporations doing business mainly in the United States are from U.S. sources. Dividends paid by foreign corporations not doing business mainly in the United States or a possession are from sources in foreign countries.
3) Interest paid on deposits with banks that do not carry on business in a possession. Interest paid on bank deposits in the United States is interest from U.S. sources.
4) Gains from the sale of securities, such as stock certificates outside a possession, are from sources in the country where the sale takes place.

Exception. For the possession-exemption rules, the United States is the source of wages, salaries, etc., paid by the U.S. Government, or any of its agencies, to U.S. citizens who are its civilian or military employees.

The following examples illustrate the sources of income and the 80% and 50% tests. It is assumed that corporations chartered in possessions (possession corporations) do business only in a possession, and that the U.S. and foreign corporations do not carry on business in a possession.

Example 1. Frank Brown is an engineer who went to work on Johnston Island for a private construction company on August 1, 1980, and remained there after December 31, 1980.

During his applicable period for 1980 (August 1 through December 31, 1980) he received wages of $3,300 on Johnston Island. He also received dividends of $400 from U.S. corporations, dividends of $100 from foreign corporations, and interest of $300 from deposits in U.S. banks. He satisfies the 80% requirement.

Possession source (wages)		$3,300
Nonpossession source income:		
Dividends (U.S.)	$400	
Dividends (foreign)	100	
Interest (U.S.)	300	800
Total income		$4,100

Gross possession source income, $3,300 ÷ Total gross income, $4,100 = 80½%

He also satisfies the 50% rule because more than half of his income is pay for personal services from sources in a possession. To determine Frank's exempt income, read the discussion under *Exempt income,* later.

Example 2. Oliver Green was employed by a private employer in American Samoa from June 15, 1979, through December 31, 1980. This is his applicable period for his 1980 tax return. During the part of 1979 that he worked in American Samoa he received wages in American Samoa of $7,600, dividends of $400 from American Samoa corporations, and dividends of $600 from U.S. corporations. During 1980 he received wages of $16,000, dividends of $2,000 from U.S. corporations, and a capital gain of $4,000 from the sale of stock in the United States.

Gross income during the applicable period for 1980 (June 15, 1979, to Dec. 31, 1980)		
Possession sources		
1979 Samoan dividends	$ 400	
1979 Samoan wages	7,600	
1980 Samoan wages	16,000	$24,000
Nonpossession sources		
1979 U.S. dividends	$ 600	
1980 U.S. dividends	2,000	
1980 Capital gain (U.S. source)	4,000	6,600
Total		$30,600

Gross possession source income, $24,000 ÷ Total gross income, $30,600 = 78%

Oliver does not qualify for the possession exemption during 1980, because he fails to satisfy the 80% requirement. He satisfies only the 50% requirement. Only wages are included in the numerator of the fraction used for the 50% requirement.

Gross possession source wages, $23,600 ÷ Total gross income, $30,600 = 77%

Example 3. George White was employed on Johnston Island by a private company from October 15, 1980, through December 31, 1980. This is his applicable period for 1980. During this period he received wages of $1,400, dividends of $1,100 from a Samoan corporation, and interest of $625 from deposits in a bank in the United States.

The 80% test is satisfied.

Gross possession source income		
Samoan wages	$1,400	
Samoan dividends	1,100	$2,500
Nonpossession source income		
U.S. bank interest		$625
Total gross income		$3,125

Gross possession source income, $2,500 ÷ Total gross income, $3,125 = 80%

George does ***not*** satisfy the 50% requirement and is not entitled to the possession exemption. Only wages are included in the numerator of the fraction used for the 50% requirement.

Gross possession source wages, $1,400 ÷ Total gross income, $3,125 = 44.8%

If You Qualify

If you meet ***both*** the 80% and 50% tests, you qualify for the possession exemption. However, all income derived during the applicable period may not be exempt.

Exempt income. To qualify for the possession exemption, income that a U.S. citizen derives during the applicable period must be from ***sources outside*** the United States and must be ***received outside*** the United States. Exempt income includes:

1) Wages ***received outside*** the United States for services performed in possessions, foreign countries, or on the high seas. Wages, including military salaries, paid by the U.S. Government or any of its agencies are not exempt because they are considered to have a U.S. source.
2) All other kinds of income (dividends, interest, royalties, rents, etc.) from ***sources outside*** the United States that are ***received outside*** the United States.

Income subject to tax. The following income of citizens who meet the possession-exemption requirements is taxable:

1) All income received during the part of the tax year that is not a part of the applicable period, described earlier. The source of that income or the place where it is received has no effect. It does not qualify for the possession exemption.
2) All income derived from U.S. sources. This includes wages for services performed in the United States, and dividends, interest, royalties, capital gains, and other income from U.S sources.
3) All wages, including military salaries, paid to employees of the U.S. Government or any of its agencies wherever they are employed.
4) All income from foreign and possession sources received in the United States.

The following examples show the importance of ***where*** foreign or possession source income is received.

Example 1. Michael Blue works during the entire year of 1980 for a private contractor on Johnston Island, a possession of the United States. His only income for the year is the $19,000 he earns on Johnston Island after his arrival there on January 1, 1980. His applicable period is January 1, 1980, to December 31, 1980, and he qualifies for the possession exemption during 1980. For his own convenience, Michael asks his employer to send his paychecks directly to his bank in the United States. In the United States the checks are credited to his account. Though he has qualified for the possession exemption, Michael must treat his 1980 possession source wages of $19,000 as taxable income, because the paychecks were ***received*** in the United States.

Michael could have treated the $19,000 wages as exempt income if he had asked his employer to give the paychecks to him on Johnston Island. He would have received the income in a possession, and it would have qualified as exempt income.

Note. The Internal Revenue Service has no objection to any arrangements made for receiving your paycheck in a possession. After receiving your paycheck, it does not matter if you or your employer actually mails it to a bank in the United States. The income remains exempt, because you received it in a possession and its source was outside the United States.

Example 2. George White qualifies for the possession exemption. He was in the United States from January 1, 1980, to March 31, 1980, and was employed in a possession during the rest of 1980. He did not work for the U.S. Government or any of its agencies. His 1980 income was as follows.

a) Wages earned in United States to 3/31/80	$2,000
b) Dividends from Swiss corporation received abroad on 2/15/80	150
c) Gain from sale of stock in U.S. on 4/21/80	400
d) Dividend from U.S. corporation received 1/24/80	200
e) Dividend from U.S. corporation received in possession 6/20/80	400
f) Interest from bank in the United States posted in January, April, August, and November 1980	300
g) Dividend from Swiss corporation deposited directly in U.S. bank on 8/13/80	150
h) Gain from sale of stock in possession on 7/23/80 (Proceeds received in possession)	1,200
i) Wages received in possession for services performed between 4/1/80 and 12/31/80	8,000
j) Dividend from Swiss corporation received in possession on 11/13/80	150
Taxable Income and Explanation:	
a) Not received in applicable period and U.S. source	$2,000
b) Not received in applicable period	150
c) Source and receipt in United States	400
d) Not received in applicable period and U.S. source	200
e) U.S. source dividends	400
f) U.S. source interest	300
g) Received in U.S.	150
Taxable income	$3,600
Exempt Income and Explanation:	
h) Source and receipt are outside U.S.	$1,200
i) Source and receipt are outside U.S.	8,000
j) Source and receipt are outside U.S.	150
Exempt income	$9,350

If You Do Not Qualify

If you do not qualify for the possession exemption because you have not met the requirements explained earlier, you should figure your tax liability in the usual manner. In other words, you should report all your taxable income, including income from foreign and possession sources. Disregard the special advice about the possession exemption. You should claim on your tax return all allowable exemptions, deductions, and credits, following the instructions for Form 1040.

You may take a credit against your U.S. tax liability if you paid income taxes to a foreign country or a possession and reported income from sources outside the United States on your tax return. The amount of foreign or possession income taxes paid that you may claim as a credit is figured on Form 1116, *Computation of Foreign Tax Credit,* which should be attached to your tax return, Form 1040. For more information, see Publication 514, *Foreign Tax Credit for U.S. Citizens and Resident Aliens.*

Filing Tax Returns

A U.S. citizen who qualifies for the exemption of income under the possession-exemption rules ordinarily may claim this exclusion by filing Form 1040, with an attached Form 4563, *Exclusion of Income from Sources in United States Possessions.* Form 4563 is an information form that allows you to show that you qualified for the possession exemption during a tax year. Form 4563 should be filed with your Form 1040, and should not be filed by itself. Form 4563 is not an income tax return. An example with a filled-in Form 4563 can be found at the end of this publication.

A U.S. citizen who can claim the possession exemption and whose gross income for the tax year is $1,000 or more must file Form 1040 (regardless of marital status). A U.S. citizen who cannot claim the possession exemption, who is single, under 65, and whose gross income for 1980 is $3,300 or more ($5,400 or more combined gross income of both spouses for a married person entitled to file jointly) must file a U.S. income tax return.

A qualifying widow(er), under 65, must file an income tax return if gross income is $4,400 or more. If 65 or older before the end of the tax year, a qualifying widow(er) must file if gross income is $5,400 or more.

A married person filing separately, or a person who received unearned income, such as interest, dividends, rents, royalties, etc., and who is a dependent of another taxpayer, must file a return if gross income for the tax year is $1,000 or more.

Example. Regina Gray, an unmarried U.S. citizen, was employed in American Samoa to teach school for the period July 5, 1978, to June 3, 1980. Her income consisted of salary

for teaching plus interest of $500 each year on deposits in a U.S. bank.

The following table shows Regina's U.S. and Samoan income for the years 1978, 1979, and 1980.

Dates in Samoa	Samoa Income
7/5/78–12/31/78	$5,000
1/1/79–12/31/79	8,000
1/1/80–6/3/80	4,000

Dates in U.S.	U.S. Income
1/1/78–7/4/78	$4,500
1979–None	500
6/3/80–12/31/80	6,500

1978—She files Form 1040 and Form 4563 because her gross taxable income ($4,500) was enough to require the filing of a U.S. tax return, and her Samoan income was exempt during the applicable period for 1978 under the possession-exemption rules.

1979—She is not required to file any U.S. federal tax return for this year, because her gross taxable income, $500, was less than $1,000.

1980—She files Form 1040 and Form 4563 because her gross taxable income, $6,500, was enough to require the filing of a U.S. tax return and her Samoan income was exempt during the applicable period.

NOTE—Regina files Samoan tax returns for all years.

Joint tax returns. You may file a joint tax return with your spouse if it is to your benefit. If you file jointly, you must use your ***total combined gross income*** in determining whether the 80% and 50% rules, explained earlier, have been met. Each of you must consider your own applicable period when determining gross income for figuring the combined gross income for the two tests.

Example. Stephen Green was employed in a possession from February 1, 1980, through December 31, 1980. His wife, Mary, joined him on June 27, 1980, and also remained to the end of the year.

Stephen and Mary received the following respective incomes during the tax year and during their applicable periods, February 1, 1980, through December 31, 1980, and June 27, 1980, through December 31, 1980.

	Applicable Periods	Non-Applicable Periods
Stephen Green		
a) Teaching in U.S., 1/1/80 through 1/30/80		$ 200
b) Teaching in poss. 2/1/80 through 12/31/80	$ 8,000	
c) U.S. source dividends received 5/28/80	400	
d) Possession source dividends received 11/7/80	200	
Mary Green		
e) Teaching in U.S., 1/1/80 through 6/23/80		4,000
f) Teaching in poss. 6/27/80 through 12/31/80	6,000	
g) U.S. source dividends received 5/28/80		400
Combined gross income	$14,600	$4,600

80% Rule

Possession source income (b + d + f), $14,200 ÷ Combined gross income, $14,600 = 97.3%

50% Rule

Wages from employment in possession (b + f), $14,000 ÷ Combined gross income, $14,600 = 95.9%

The combined gross income received during their applicable periods shows that they would qualify for the possession exemption on a joint return. This means that their possession source income ($14,200) received during their applicable periods is exempt.

Their taxable gross income of $5,000 consists of the following.

Combined gross income for nonapplicable period	$4,600
U.S. source dividends received 5/28/80 (Stephen)	400
Total combined gross income for year	$5,000

On their joint return Stephen and Mary may deduct only one personal exemption of $1,000. They must follow the rules and restrictions on deductions, explained below. To figure their actual tax liability, they should use Tax Table H for married persons filing jointly, shown in the Instructions for Form 4563.

Figuring Taxable Income

If you take advantage of the possession exemption, you must accept ***unusual restrictions*** and ***special rules*** in claiming deductions. These rules reduce or completely eliminate certain deductions and credits that you could otherwise claim. Nevertheless, you must observe the following rules ***if you want the possession exemption.***

Exemptions

1) You may deduct ***only one personal exemption*** of $1,000. If you have a spouse and two children, you may deduct only $1,000, and not $4,000 ($1,000 × 4), which is the normal deduction for personal exemptions allowed for a husband and wife and two children. Even if you file a joint return, you may ***not*** deduct the usual $1,000 exemption for each child and your spouse.
2) You may ***not*** claim additional exemptions for blindness or age (65 years or over).

Deductions

1) You may claim deductions if they are connected with, and do not exceed, your income from sources within the United States.
2) You may claim a deduction for losses incurred in certain profit-motivated transactions that are not reimbursed by insurance, though not connected with a trade or business. These transactions must be of a kind that would yield a taxable profit if they turned out to be profitable.
3) You may claim a deduction for casualty and theft losses to property located in the United States and not reimbursed by insurance, even though the losses are not connected with a trade or business in the United States. If the property is not located in the United States, such losses are not allowable.
4) You are ***not*** entitled to the zero bracket amount that is incorporated in the tax tables and the tax rate schedules. You must, therefore, add any unused zero bracket amount (excess of zero bracket amount over allowable itemized deductions) to income.
5) You may ***not*** claim a deduction for expenses that you incurred to earn exempt income.
6) You may ***not*** claim the deduction for medical expenses.
7) You may ***not*** ordinarily claim deductions for taxes and interest. However, if such expenses are connected with your income from sources within the United States, they may be deducted. See paragraph (1).
8) You may ***not*** claim the deduction for contributions to foreign churches and charitable organizations unless the organizations have been approved by the Internal Revenue Service for deductible contributions.

Credits

1) You may ***not*** claim a credit for income taxes paid to a foreign country or to a possession of the United States.
2) You may ***not*** claim the earned income credit if you are entitled to claim the possession exemption. For 1980, this is a refundable credit of 10% of your first $5,000 of earned income, or $500. The amount of the credit is reduced by 12.5% of the amount of your adjusted gross income (or earned income, if greater), which is more than $6,000.

Example. Larry Black, a teacher, arrived in a possession with his wife and three children on March 3, 1980, and was employed there until the end of the year. His income, expenses, etc., are as follows.

1) Wages in United States (1/1/80 to 3/2/80)	$4,000
2) Wages in possession (3/3/80 to 12/31/80)	10,000
3) Income tax paid to possession	600
4) Cost of teaching aids used in U.S. employment	200
5) Cost of teaching aids used in possession employment	300
6) Theft of nonbusiness property in United States	250
7) Theft of nonbusiness property in possession	210
8) Contributions to qualified churches created in the United States and the possession	200
9) Medical expenses	500
10) Taxes on unrented house in the United States	300
11) Interest on mortgage on above house in the United States *	400
12) Wife and three children	
13) Larry became 65 years of age in 1980	

*House was not available for rent

Larry has met the possession-exemption rules. The following table shows how Larry's taxable income is figured. Larry is not entitled to the zero bracket amount and must itemize his allowable deductions on Schedule A (Form 1040), following the rules listed earlier. Because the zero bracket amount is automatically allowed on the tax tables, any un-

used zero bracket amount (the excess of the zero bracket amount over allowable itemized deductions) must be added to the income before determining Larry's tax:

	Allowable Deductions	Taxable Income
1) Taxable gross income (U.S. source)		$4,000
2) Possession source wages are exempt under the possession-exemption rules		-0-
3) Income tax paid a possession is not an allowable deduction if it is attributable to exempt income	-0-	
4) Cost of teaching aids is deductible because it is attributable to taxable income	$200	
5) Cost of teaching aids in possession not deductible because cost of teaching aids is attributable to exempt possession income	-0-	
6) Deductible theft loss because nonbusiness property stolen was in the United States. $250 minus $100 (the limitation on casualty and theft losses)	150	
7) Theft loss not deductible because this nonbusiness property was not in the United States	-0-	
8) Contributions to qualified churches created in the United States and the possession, and to other qualified organizations, are deductible	200	
9) Medical expenses are not deductible	-0-	
10) Taxes on house in the United States are not deductible. (If the house were rented, however, taxes could be deducted from rental income as a business expense.)	-0-	
11) Interest on mortgage on house is not deductible. (If the house were rented, however, interest could be deducted as a business expense.)	-0-	
Totals	$550	$4,000
12) Zero bracket amount	$3,400	
Minus: Itemized deductions	550	
Unused zero bracket amount—added		2,850
13) Tax table income		$6,850
14) Tax—figured using Tax Table H that is in the Instructions for Form 4563. (One personal exemption allowed. Exemptions for spouse, children, old age, and blindness are not allowable)		$ 346

Figuring your tax. If you take the exclusion, you must itemize your deductions on Schedule A (Form 1040). If the amount on Schedule A, line 40, is more than the amount on line 39, fill in Schedule TC (Form 1040), Part II, to figure how much to enter on Form 1040, line 34.

If you use the tax table to find your tax and are either married and filing jointly or a qualifying widow or widower, please use Tax Table H. If you are single, married filing separately, or head of household, use the column for one exemption in the tax tables found in the Form 1040 instructions.

Note. If you take the possession exemption, you may not figure your U.S. income tax under the income averaging method on Schedule G (Form 1040).

Where to file. Attach the completed Form 4563 to your Form 1040 and file it with the Internal Revenue Service Center, Philadelphia, PA 19255.

Exemption Not Claimed

Because of the restrictions and rules discussed previously, it may not be to your advantage to claim the possession exemption. Your tax liability may be less without the possession exemption than with it. You need not claim the possession exemption if it is not to your benefit.

If you do not claim the possession exemption, prepare your tax return in the usual way. Report on your tax return all taxable income, including income from possession sources, and claim all credits, exemptions, and deductions according to the Instructions for Form 1040. The following example shows a taxpayer who did not claim the possession exemption.

Example. Bob Gray earned $7,000 working in the United States from January 1, 1980, to June 2, 1980, and $8,000 working on Wake Island from June 3, 1980, to December 31, 1980. He has a wife and six dependent children. He contributed $250 to his church. In a car accident in the United States, he suffered a casualty loss of $180 that was not covered by insurance. After applying the $100 limitation, he may deduct $80 of this loss on his car (used for pleasure).

Bob did not claim the possession exemption because his total tax was lower without it. The two computations are as follows.

With possession exemption:		
Gross income (U.S. source only)		$7,000
Church contributions	$ 250	
Allowable casualty loss (Property in U.S.) $180 − 100	80	
	$ 330	
Adjustment for unused zero bracket amount:		
Zero bracket amount	$3,400	
Minus: Itemized deductions	330	
Unused zero bracket amount—added		3,070
Tax table income		$10,070
Tax—figured using Tax Table H, which is in the Instructions for Form 4563		$ 896
Without possession exemption:		
Gross income (U.S. source)	$7,000	
Gross income (Wake Island)	8,000	
Tax table income		$15,000
Tax—figured with 8 allowable exemptions from Tax Table B—Married filing jointly		$ 530

Note. You should figure your total tax with and without the possession exemption and use the lower tax liability.

Community Property

Married U.S. citizens who are domiciled in states or possessions that have community property laws must make a ***special computation*** to determine whether they qualify for the possession exemption. The following states have these laws and are community property states.

Arizona	Nevada
California	New Mexico
Idaho	Texas
Louisiana	Washington

To determine whether they meet the 80% and 50% tests, married U.S. citizens domiciled in a community property state must use gross income, as figured under the community property laws of their state.

Example. Mr. and Mrs. Henry Brown are domiciled in California, a community property state. During the tax year, Mr. Brown worked in a possession and earned $10,000. During that year, Mrs. Brown worked in the United States and earned $6,000. Under the community property laws of California, each spouse owns one-half of the community income. Since compensation for personal services is community income in California, each spouse owns one-half of his or her own wages plus one-half of the wages of the other spouse. The following table shows Mr. Brown's gross income under both the noncommunity and community property rules.

	Noncommunity Property	Community Property
U.S. source income (Mrs. Brown's wages)	-0-	$3,000
Possession source income (Mr. Brown's wages)	$10,000	5,000
Total	$10,000	$8,000

In the ordinary sense, Mr. Brown's gross income consists only of the $10,000 wages from possession sources. On the basis of that income he would meet the 80% and 50% rules. However, because he is domiciled in a community property state, he must determine his gross income under the community property laws. This means that his gross income is only $8,000. It consists of half of his wife's U.S. source wages ($3,000) and half of his own possession source wages ($5,000). On the basis of community property laws, he does not satisfy the 80% requirement. The ratio of his possession source gross income to total gross income is less than 80%.

Possession source gross income, $5,000 ÷ Total gross income, $8,000 = 62.5%

Mr. Brown does not qualify for the possession exemption. He must observe the community property laws of his state of domicile in determining the amounts of community income that legally belong to him. In other words, he must use the $8,000 figure, which is the income that is legally his under the California community property laws and not the $10,000 figure, which is the actual amount of his wages for the year.

Since Mr. Brown does not meet the possession-exemption rules, it will probably be best for Mr. and Mrs. Brown to file Form 1040 jointly as if they were both living in the United States. If Mr. Brown had to pay income tax to the possession, he could take a credit against his U.S. tax liability for the possession tax paid up to the amount allowed as a foreign tax credit. See Publication 514, *Foreign Tax Credit for U.S. Citizens and Resident Aliens.*

The example of Mr. and Mrs. Brown is a simplified illustration of the principle that married U.S. citizens domiciled in community property states must treat community income as owned equally by each spouse. Community income may consist of income from community or separate property and also wages

earned by both spouses, as in the case of Mr. and Mrs. Brown of California.

U.S. citizens domiciled in certain community property states may also derive separate income in addition to their community income. They must consider both community and separate gross income for the possession exemption. In determining whether they satisfy the 80% and 50% rules, they must determine their gross income as follows:

Separate Gross Income

+ Half of Community Gross Income

= Gross Income for Purposes of 80% and 50% Rules

The meanings of such terms as domicile, community property, community income, separate property, and separate income may vary from state to state. The laws of the state in which you are domiciled determine your treatment of community property and community income.

Domicile. You have only one domicile, but you may have more than one residence. Your domicile is a permanent legal residence used for an indefinite period of time. The question of domicile is mainly a matter of your intention. If your domicile or residency is questioned, you must be able to show, with facts, that you intend a given place or state to be your permanent home. Length of time spent in one place does not necessarily distinguish a residence from a domicile. A temporary residence may continue for months or years, while a domicile may be established the first moment you occupy the property. Your intent is the controlling element in determining where you actually have your domicile.

Community property is all property, not falling within the definition of separate property, acquired by the husband and wife during their marriage while they are domiciled in a community property state. Each owns half of all the property, according to state law. All community property belongs as much to the wife as it does to the husband. There are exceptions to this general rule and these vary in the different states. In California, property acquired during marriage before July 29, 1927, if it otherwise qualifies as community property under California law, is treated for federal tax purposes as the separate property of the husband. It remains his separate property as long as it can be so traced. If property cannot be identified as separate property, it will be considered as community property. Income from community property is community income. It is important for federal tax purposes to classify property according to the laws of the state in which you are domiciled.

Community income is all the income from community property and salaries, wages, and other compensation for the services of either or both the husband and wife. In some states, income from separate property is also community income. If a husband and wife elect to file separate returns, half of all community income must be reported by one spouse, and the other half by the other spouse. There are also exceptions to this general rule.

For example, under the laws of Nevada one spouse may permit the other spouse to treat that other spouse's earnings as separate income. In such a case, the spouse earning the income must report all earnings on that spouse's separate return if the husband and wife choose to file separate returns. On the other hand, if you live in Texas, the wages of both spouses are community income.

Separate property is all property owned separately by you and your spouse before your marriage. It is also property that is acquired after marriage by you or your spouse separately as a gift, devise, bequest, or inheritance. Separate property may be acquired during marriage by buying with separate funds or in exchange for separate property. In some community property states, a spouse's personal injury award is that spouse's separate property. Generally, once property is classified as separate property, it remains separate property as long as it can be traced.

Separate income is not necessarily the income from separate property. Generally, under the community property system, income from separate property is income of the spouse who is considered to own the property. However, income from separate property is sometimes recognized to be community income. The method of treating income arising from separate property varies in different states.

Income from property acquired with commingled funds. Generally, if you acquire property during your marriage with both community funds and separate funds, the income from that property must be allocated. Income from the part of the property acquired with community funds is always community income. Income from the part of the property acquired with separate funds is community income or separate income, depending on the laws of the state of domicile.

Expenses. The expenses for producing income, such as rents, royalties, dividends, and salaries are classed as community or separate expenses that are deductible according to how the respective income is classified.

Example. You and your spouse own an apartment house. In the state in which you are domiciled, the apartment house is community property. If you file separate federal income tax returns, you each will report half of the income from the property, and neither may deduct more than half the expenses incurred for the operation of the apartment house.

Tax deductions listed on Schedule A (Form 1040), such as charitable contributions, interest, taxes, and medical expenses are generally considered to be paid from community funds and to be deductible half by each spouse. If it can be proved, however, that they were actually paid from separate funds of the husband or wife, they are ordinarily deductible on the return of the spouse who paid them. The taxpayer who meets the possession-exemption rules must follow the guidelines for deductions that were explained previously.

Self-Employment Tax

A U.S. citizen who owns and operates a business in Puerto Rico, Guam, the Northern Mariana Islands, American Samoa, or the Virgin Islands must pay tax on net self-employment earnings of $400 or more from those sources. This rule applies whether or not such earnings are exempt from U.S. income taxes (or whether or not a U.S. income tax return is required). Unless one of the following special income tax rules applies, attach Schedule SE (Form 1040) to your U.S. income tax return. If you receive self-employment income from sources in Guam or the Northern Mariana Islands or self-employment income from sources in American Samoa that is exempt from U.S. income tax, use Form 1040SS to figure your self-employment tax. If you are a bona fide resident of the Virgin Islands, and do not pay income tax to the United States, use Form 1040SS.

For self-employment income from sources in Puerto Rico, file Form 1040SS, or Form 1040PR if appropriate. These forms must be filed with the Internal Revenue Service Center, Philadelphia, PA 19255.

Credit for Excess FICA Employee Tax Withheld

If you worked for two or more employers during 1980 and together they paid you more than $25,900 in wages, too much social security tax or railroad retirement tax may have been withheld from your wages. If the amount of these taxes withheld by each employer was $1,587.67 or less, and the total amount withheld by all employers was more than $1,587.67, you may claim a refund for the excess amount withheld by filing Form 843, *Claim.*

Residents of Puerto Rico and the Virgin Islands should file their claim with the Director of International Operations, U.S. Internal Revenue Office, Hato Rey, Puerto Rico 00918.

Residents of Guam, the Northern Mariana Islands, and American Samoa should file their claim with the Director of International Operations, U.S. Internal Revenue Service, Washington, D.C. 20225.

Filing Requirements for Certain U.S. Possessions

Guam, the Northern Mariana Islands, the Virgin Islands, Puerto Rico, and American Samoa have their own independent tax departments. A U.S. citizen who derives income from sources in these islands will probably have to file a tax return with one of these island tax departments. It is also possible that a U.S. citizen may have to file two annual tax returns; one with the island tax department and the other with the U.S. Internal Revenue Service.

Requests for forms and technical advice about the filing of island tax returns should be obtained from that island's tax department and not the Internal Revenue Service. In some situations you may have to determine if

you are a resident or a nonresident of a certain island. Contact the tax department of that island for advice about this point.

The following short discussions describe the filing requirements for U.S. citizens who derive income from sources in Guam, the Northern Mariana Islands, the Virgin Islands, Puerto Rico, and American Samoa.

Guam

Guam has its own separate and independent tax system, based on the same tax laws and tax rates that apply in the United States. Requests for advice about Guam residency and tax matters should be addressed to the:

Commissioner of Revenue and Taxation
Government of Guam
Agana, Guam 96910

The following discussion covers the basic tax rules for residents and nonresidents of Guam.

If you are a U.S. citizen who derives income from Guam and United States sources, you do not have to file income tax returns with both jurisdictions. You must file with either Guam or the United States, but not both. You are relieved of any income tax liability to the jurisdiction with which you are not required to file. If a return is required, you must include income from all sources (including the U.S. and Guam). If you are employed in Guam, the possession exemption does not apply.

If you are a resident of Guam on the last day of your tax year, you should file your return with the Commissioner of Revenue and Taxation, Government of Guam, Agana, Guam 96910. Include any balance of tax due on income derived from all sources with your tax return.

If you are a resident of the United States on the last day of your tax year, you should file your return with the Internal Revenue Service Center, Philadelphia, PA 19255. Include any balance of tax due on income derived from all sources with your tax return.

If you are neither a resident of Guam nor of the United States at the end of your tax year, you should file with Guam if you are a citizen of Guam but not otherwise a citizen of the United States (i.e. born or naturalized in Guam). Otherwise, you should file with the United States.

Your place of residence is determined primarily by your intentions regarding the length and the nature of your stay. If an extended period of time is required for the purpose of your stay and your home is made temporarily at that place, you are considered a resident even though you intend to eventually return to a domicile at some other location.

However, if your visit is for a definite purpose, which can be done quickly, you are not considered a resident.

If you file a joint return, you should file it (and pay the tax) with the jurisdiction where the spouse who has the greater adjusted gross income would be required to file (if filing separately). If the spouse with the greater adjusted gross income is a resident of Guam at the end of the tax year, file the joint return with Guam. If the spouse with the greater adjusted gross income is a resident of the United States at the end of the tax year, file the joint return with the United States. For this purpose, income is determined without regard to community property laws.

U.S. Armed Forces personnel. If you are a member of the U.S. Armed Forces stationed on Guam, you are not considered a resident of Guam and you must file your return with the United States. However, if you are a civilian employee of the military, you are subject to the same rules, described earlier, as other U.S. citizens who live on Guam. If you are a resident of Guam on the last day of your tax year, file your return with Guam.

If you are required to file a declaration of estimated tax, file it with the jurisdiction (United States or Guam) where you would file your income tax return if your tax year were to end on the date your estimated tax return is first due. Generally, you should make your quarterly payments of estimated tax and any later amendments to the declaration with the jurisdiction where you filed your original estimated tax return. However, see *Early filing of declaration.*

If you file a joint declaration of estimated tax, file it with the jurisdiction where the spouse who has the greater estimated adjusted gross income would be required to file (if a separate declaration were filed). For this purpose, income is determined without regard to community property laws.

Example. Bill Tann is single and files his return on a calendar year basis. He is a resident of the United States at the time that he must file his 1981 declaration of estimated tax. Bill does not expect to be a resident of Guam at the end of 1981, and so on April 15, 1981, he files his estimated tax return with the United States. However, later in 1981, Bill becomes a resident of Guam and receives income from Guam sources, which requires an amendment of his declaration. Both the amended declaration and the quarterly estimated tax payments must be made to the United States, because he was a U.S. resident when his declaration of estimated tax was first due. Since Bill is a resident of Guam at the end of his tax year, his 1981 income tax return is filed with Guam. On that return he claims credit for the estimated tax payments made to the United States.

Early filing of declaration. If you filed an early declaration of estimated income tax in a jurisdiction other than the one required on the actual first due date for filing, you must make all later amendments and installments in the jurisdiction where the declaration would have been filed on that first required filing date.

Example. Peg Gray is single and files her returns on a calendar year basis. On March 1, 1981, Peg is a resident of the United States and files her 1981 declaration of estimated tax and pays her first installment to the United States. Before the date Peg would otherwise be required to file her 1981 declaration of estimated tax (April 15, 1981), she becomes a resident of Guam for the rest of the year. Peg must make the rest of her installment payments of estimated tax to Guam because she is a resident of Guam on the date that her declaration of estimated tax is first due, April 15, 1981. At the end of 1981, Peg will file her income tax return with Guam and claim credit for all estimated tax installments on that return.

Income taxes withheld and estimated tax payments are taken into account in determining if the return results in a balance of tax due or an overpayment, whether or not the withholdings or payments were actually received by the jurisdiction with which the return must be filed. Any liability for underpayment of estimated tax is payable to the jurisdiction where you file your return.

Example 1. Paul Green was a resident of Guam during the entire year of 1980. His 1980 income consisted of wages of $10,000 paid by a private employer, and dividends of $4,000 from U.S. corporations that carry on business primarily in the United States.

He must file a 1980 income tax return with the Government of Guam. He reports his gross income of $14,000 on this return.

Example 2. William Black, a U.S. citizen was employed by a private company in Guam from June 2, 1980, through December 31, 1980. He received a salary of $10,000 during that period for his work in Guam, $4,000 in dividends from U.S. corporations that carry on business primarily in the United States, and $1,000 in interest from deposits in U.S. banks. After contacting the Guam Commissioner of Revenue and Taxation, William was advised that he was not a resident of Guam. Therefore, he must file a U.S. tax return. On his U.S. tax return he reported the $4,000 of dividends, the $1,000 of interest, and the $10,000 Guam salary.

Example 3. Bill White, a U.S. citizen, was a resident of the United States, and Mrs. White, a citizen of Guam, was a resident of Guam, at the end of 1980. Bill's income consisted of a $15,000 salary as an engineer. Mrs. White earned $10,000 as a teacher in Guam. Mr. and Mrs. White filed a joint return. Since Bill has the greater adjusted gross income, they must file their return with the United States and report the entire $25,000 on this return.

Information return. If your adjusted gross income from all sources is at least $50,000, consists of at least $5,000 of gross income from sources in Guam, and you are required to file a U.S. income tax return, attach Form 5074, *Allocation of Individual Income Tax to Guam or Northern Mariana Islands,* to Form 1040. Form 5074 may be obtained from most Internal Revenue offices. If you need assistance, contact the Office of International Operations, Internal Revenue Service, Washington, D.C. 20225.

Northern Mariana Islands

The Northern Mariana Islands has its own separate and independent tax system based

on the same tax laws and tax rates that apply to the United States. Requests for advice about residency and tax matters should be addressed to the Division of Revenues, Saipan, Mariana Islands 96950.

The following discussion covers the basic tax rules for residents and nonresidents of the Northern Mariana Islands.

For tax years beginning after January 8, 1978, if you are a U.S. citizen who derives income from the Northern Mariana Islands and United States sources, you do not have to file income tax returns with both jurisdictions. You must file with either the Northern Mariana Islands or the United States, but not both. You are relieved of any income tax liability to the jurisdiction with which you are not required to file. If a return is required, you must include income from all sources (including the U.S. and Northern Mariana Islands).

If you are a resident of the Northern Mariana Islands on the last day of your tax year, you should file your return with the Division of Revenues, Saipan, Mariana Islands, 96950. Include any balance of tax due on income derived from all sources with your tax return.

If you are a resident of the United States on the last day of your tax year, you should file your return with the Internal Revenue Service Center, Philadelphia, PA 19255. Include any balance of tax due on income derived from all sources with your tax return.

If you are neither a resident of the Northern Mariana Islands nor of the United States at the end of your tax year, you should file with the Division of Revenues, Saipan, Mariana Islands 96950, if you are a citizen of the Northern Mariana Islands and with the Internal Revenue Service Center, Philadelphia, PA 19255, if you are a citizen of the United States.

Your place of residence is determined primarily by your intentions regarding the length and the nature of your stay. If an extended period of time is required for the purpose of your stay and your home is made temporarily at that place, you are considered a resident even though you intend to eventually return to a domicile at some other location.

However, if your visit is for a definite purpose, which can be done quickly, you are not considered a resident.

If you file a joint return, you should file it (and pay the tax) with the jurisdiction where the spouse who has the greater adjusted gross income would be required to file (if filing separately). If the spouse with the greater adjusted gross income is a resident of the Northern Mariana Islands at the end of the tax year, file the joint return with the Northern Mariana Islands. If the spouse with the greater adjusted gross income is a resident of the United States at the end of the tax year, file the joint return with the United States. For this purpose, income is determined without regard to community property laws.

If you are required to file a declaration of estimated tax, file it with the jurisdiction (United States or the Northern Mariana Islands) where you would file your income tax return if your tax year were to end on the date your estimated tax return is first due. Generally, you should make your quarterly payments of estimated tax and any later amendments to the declaration with the jurisdiction where you filed your original estimated tax return. However, see *Early filing of declaration.*

If you file a joint declaration of estimated tax, file it with the jurisdiction where the spouse who has the greater estimated adjusted gross income would be required to file (if a separate declaration were filed). For this purpose, income is determined without regard to community property laws.

Early filing of declaration. If you filed an early declaration of estimated tax in a jurisdiction other than the one required on the actual first due date for filing, you must make all later amendments and installments in the jurisdiction where the declaration would have been filed on that first required filing date.

Income taxes withheld and estimated tax payments are taken into account in determining if the return results in a balance of tax due or an overpayment, whether or not the withholdings or payments were actually received by the jurisdiction with which the return must be filed. Any liability for underpayment of estimated tax is payable to the jurisdiction where you file your return.

Information return. If your adjusted gross income from all sources is at least $50,000, consists of at least $5,000 of gross income derived from sources in the Northern Mariana Islands, and you are required to file a U.S. income tax return, attach Form 5074, *Allocation of Individual Income Tax to Guam or Northern Mariana Islands,* to Form 1040. Form 5074 may be obtained from most Internal Revenue offices. If you need assistance, contact the Office of International Operations, Internal Revenue Service, Washington, D.C. 20225.

The Virgin Islands

An important factor in Virgin Islands taxation is whether one, on the last day of the tax year, has made a home in the Virgin Islands as a bona fide resident and is not a visitor or tourist.

If you are a U.S. citizen and a bona fide resident of the Virgin Islands on the last day of the tax year, you file your annual tax return with the Government of the Virgin Islands and pay the entire tax due to the Virgin Islands. You are not required to file a U.S. federal income tax return for any tax year in which you are a bona fide resident of the Virgin Islands on the last day of the year.

Example. Mr. and Mrs. Brown left the United States on December 1, 1980, and landed in the Virgin Islands on the same day. Since they went for the purpose of making their home in the Virgin Islands, they qualified as bona fide residents of the Virgin Islands on the last day of their tax year, December 31, 1980.

Mr. and Mrs. Brown file their 1980 income tax return with the Government of the Virgin Islands and pay the entire tax for that year to the Virgin Islands. Even though they lived in the United States most of the year, their income tax obligations for that year are completely under the jurisdiction of the Government of the Virgin Islands.

If you are a U.S. citizen who derives income from Virgin Islands sources and you are ***not*** a bona fide resident of the Virgin Islands on the last day of your tax year, you must file both Virgin Islands and U.S. federal income tax returns. On the Virgin Islands tax return you will report only your income from Virgin Islands sources. On the U.S. federal tax return you will report your income from worldwide sources, including the Virgin Islands. You may claim credit on the U.S. tax return for the income taxes you must pay to the Virgin Islands up to the amount allowed as a foreign tax credit. See Publication 514, *Foreign Tax Credit for U.S. Citizens and Resident Aliens.*

Example. Jane Blue, a U.S. citizen, was employed in the Virgin Islands from September 4, 1979, to May 30, 1980. She went to the Virgin Islands for temporary employment and ***not*** to make her home there. Therefore, she was ***not*** a bona fide resident of the Virgin Islands on the last day of the tax year even though she was present there on that date.

Jane must file two tax returns for each year. On her 1979 and 1980 Virgin Islands tax returns, she should report only her income from Virgin Islands sources during those years. The wages she received for working in the Virgin Islands is income from Virgin Islands sources. On her U.S. tax returns she should report income from worldwide sources received during those years. She may take a credit against each year's U.S. tax liability for the income taxes paid or accrued to the Virgin Islands for each year.

Virgin Islands tax returns should be filed with the Department of Finance, Tax Division, Charlotte Amalie, St. Thomas, Virgin Islands 00801. Contact that office for information about the filing of such tax returns.

Note. A mutual agreement procedure exists ***to settle cases of double taxation*** between the United States and the Virgin Islands. Address your request for assistance under this procedure to the Director of International Operations, Internal Revenue Service, P.O. Box 19007, Washington, D.C. 20036, or to the Commissioner of Finance, P.O. Box 2515, Charlotte Amalie, St. Thomas, Virgin Islands 00801.

Commonwealth of Puerto Rico

The Commonwealth of Puerto Rico has its own separate and independent tax system. It is modeled after the U.S. system but there are variations in law and tax rates. A U.S. citizen who derives income from Puerto Rican sources will be liable for payment of Puerto

Rican taxes. The individual may also be liable for filing a U.S. tax return. Requests for forms and other information about the filing of Puerto Rican tax returns should be sent to Oficina de Apelaciones Administrativas, Consultas y Legislación, Negociado de Contribución sobre Ingresos, Apartado S 2501, San Juan, Puerto Rico 00903. The filing requirements for U.S. citizens who are residents and nonresidents of Puerto Rico are included in the following discussions.

Puerto Rican taxation. Since the source of income is an important factor in Puerto Rican taxation, see *Sources of income*, discussed earlier.

Residents of Puerto Rico. If you are a U.S. citizen and also a resident of the Commonwealth of Puerto Rico, you are generally liable for the payment of tax to Puerto Rico on your income from worldwide sources. Any wages and the cost-of-living allowance paid to you by the U.S. Government for working in Puerto Rico are subject to Puerto Rican tax. Advice about possible tax benefits under the Puerto Rican investment incentive programs is available from the Puerto Rican tax authorities. If you report U.S. source income on the Puerto Rican tax return, you may claim a credit against the Puerto Rican tax, up to the amount allowable, for income taxes paid to the United States.

Nonresidents of Puerto Rico. If you are a U.S. citizen and are not a resident of the Commonwealth of Puerto Rico, you are liable for the payment of tax to Puerto Rico only on your income from Puerto Rican sources. Wages that you earn for services performed in Puerto Rico for the U.S. Government or for private employers is income from Puerto Rican sources.

U.S. taxation. As a U.S. citizen, wherever you may be a resident, you are liable for the payment of U.S. federal income tax on your gross income from worldwide sources. However, a special rule applies if you are a bona fide resident of Puerto Rico for an entire tax year or have been a bona fide resident of Puerto Rico for at least 2 tax years and later change your residence from Puerto Rico during a tax year.

Income you received from Puerto Rican sources during your residence there, or year of change, is exempt from U.S. tax. However, income you received for services performed in Puerto Rico as an employee of the United States must be reported on your U.S. income tax return.

Deductions. Deductions that apply to your exempt Puerto Rican income are not deductible on your federal income tax return.

Deductions that do not specifically apply to any particular type of income must be allocated between your income from Puerto Rican sources and income from all other sources to find the part that you may deduct on your U.S. tax return. Examples of deductions that do not definitely apply to a particular type of income are alimony payments and certain itemized deductions (such as medical expenses, charitable contributions, and real estate taxes and mortgage interest on your personal residence). To find the part of the deduction that is allowable, multiply the deduction to be allocated by a fraction. The numerator of the fraction is your gross income from sources outside Puerto Rico, and the denominator is your total gross income from all sources.

Example. You and your spouse are bona fide residents of Puerto Rico during all of 1980. You file a joint return. You received $25,000 of income from Puerto Rican sources, and $15,000 from sources outside of Puerto Rico during 1980. You have $16,000 of itemized deductions that do not apply to any specific type of income (real estate taxes and mortgage interest on your personal residence, medical expenses, and charitable contributions). The part of your deductions that are allowable on your federal tax return is figured as follows.

Allocation of itemized deductions to U.S. income:

($15,000/$40,000) × $16,000 =	$6,000
Minus: Zero bracket amount	3,400
Allowable excess itemized deductions	$2,600

Zero bracket amount. Like the deductions discussed above, the zero bracket amount does not apply to any particular type of income. The part of the zero bracket amount that is allocated to your Puerto Rican income must be added back to your income because the zero bracket amount is built into the tax tables and tax rate schedules. To find the part of the zero bracket amount that applies to your Puerto Rican income, multiply the zero bracket amount by a fraction. The numerator of the fraction is your gross income from Puerto Rican sources, and the denominator is your gross income from all sources. This adjustment must be made before you can determine if you must file a U.S. tax return because the minimum income level at which you must file a return is based, in part, on the zero bracket amount for your particular filing status. For example, in 1980, a return must be filed by a single individual, under 65, with gross income of $3,300 (zero bracket amount of $2,300 plus $1,000, one exemption).

Example. James and Mary Ash, both under 65, are U.S. citizens and bona fide residents of Puerto Rico. They file a joint income tax return. During 1980, they received $15,000 of income from Puerto Rican sources and $4,000 of income from sources outside Puerto Rico. They do not itemize their deductions. In 1980, married individuals filing joint tax returns who are both under 65, must file a return if their combined gross income is $5,400 or more. The zero bracket amount for married individuals filing a joint return is $3,400. Their U.S. tax table income is $6,684, figured as follows:

Income from sources outside Puerto Rico	$4,000
Plus: Part of zero bracket amount allocated to income from Puerto Rican sources ($15,000/$19,000) × $3,400	2,684
U.S. tax table income	$6,684

Because of this adjustment, they must file a U.S. tax return.

Personal exemptions are allowed in full and need not be allocated.

If you are a U.S. citizen and are ***not a bona fide resident of Puerto Rico*** for the entire tax year, you must report on your U.S. tax return all of your Puerto Rican income as well as all other income from worldwide sources.

Foreign tax credit. If you are required to report Puerto Rican income on a U.S. tax return, you may claim a credit, up to the amount figured on Form 1116, for income taxes paid to Puerto Rico. The following example illustrates the taxation of U.S. citizens who have been bona fide residents of Puerto Rico for their entire tax year.

Example. John and Mary Reddy were bona fide residents of Puerto Rico during the entire year of 1980, and received the following income in that year.

John:
$10,000 wages as an employee of the U.S. Government working in Puerto Rico.
$200 dividend from a Puerto Rican corporation that does business in Puerto Rico.
$400 dividend from a United Kingdom corporation that does business in the United Kingdom.
$600 dividend from a U.S. corporation that does business in the United States.
Mary:
$6,000 wages from a Puerto Rican corporation for services performed in Puerto Rico.

The following table shows their exempt and taxable income for U.S. federal income tax purposes. They may file a joint tax return.

	Taxable	Exempt
John's wages	$10,000	
(U.S. Gov't. wages are not exempt)		
Mary's wages		$6,000
Puerto Rican corporation dividend		200
(Puerto Rican source income is exempt)		
U. K. corporation dividend	400	
(Income from sources outside Puerto Rico is taxable)		
U.S. corporation dividend	600	
Totals	$11,000	$6,200

John and Mary must file 1980 income tax returns with both Puerto Rico and the United States. They have gross income of $11,000 for U.S. tax purposes and $17,200 for Puerto Rican tax purposes. A tax credit may be claimed on the U.S. tax return for income taxes paid to Puerto Rico and on their Puerto Rican return for income taxes paid to the United States. The credit to be taken on the U.S. tax return is figured on Form 1116, which must be attached to the U.S. tax return, Form 1040.

Earned income credit. If you maintain a household in Puerto Rico that is your principal home and the home of your qualifying child, you may not claim the earned income credit on your U.S. tax return. This credit is available only if you maintain such a household in the United States.

Note. A mutual agreement procedure exists ***to settle cases of double taxation*** between the United States and the Commonwealth of Puerto Rico. Address your requests for assist-

ance under this procedure to the Director of International Operations, Internal Revenue Service, P.O. Box 19007, Washington, D.C. 20036, or to the Assistant Secretary for Internal Revenues, Department of the Treasury, Commonwealth of Puerto Rico, San Juan, Puerto Rico 00906.

American Samoa

American Samoa has its own separate and independent tax system. Although its tax laws are modeled on the U.S. Internal Revenue Code, there are certain differences. Requests for advice about matters connected with Samoan taxation should be sent to the Tax Manager, Government of American Samoa, Pago Pago, American Samoa 96799.

Residents of Samoa. If you are a U.S. citizen and a resident of Samoa, you must report your gross income from worldwide sources on your Samoan tax return. If you report non-Samoan source income on the Samoan tax return, you may claim a credit against the Samoan tax liability for income taxes paid to the United States, a foreign country, or another possession.

If you are a resident of Samoa for part of the tax year and you then leave Samoa, you must file a tax return with American Samoa for the part of the year you were present in Samoa.

Nonresidents of Samoa. If you are a U.S. citizen and are not a resident of Samoa, you should report only income from Samoan sources on your Samoan tax return.

U.S. Government employees. If you are ***employed in Samoa*** by either the U.S. Government or any of its agencies, or by the Government of American Samoa, you are subject to tax by Samoa on your pay from either government. Whether you are subject to tax by Samoa on your non-Samoan source income depends on your status as a resident or nonresident.

Wages and salaries paid by the Governments of the United States and American Samoa to U.S. citizens are also subject to U.S. federal income tax. These payments are not exempt under the possession-exemption rules.

Ordinarily, this means that you must file both U.S. and Samoan tax returns. Single taxpayers whose total gross income during 1980 is less than the minimum requirement for filing tax returns ($3,300, or $4,300 if the taxpayer is 65 or older) do not have to file. A qualifying widow(er) whose gross income is less than $4,400 ($5,400 if 65 or older) does not have to file. For married taxpayers filing joint returns, the minimum filing requirement for 1980 is $5,400, increased by $1,000 for each spouse age 65 or older. For married taxpayers filing separate returns, the minimum amount is $1,000.

If you report such governmental wages on both U.S. and Samoan tax returns, you may take a credit on your U.S. tax returns for income taxes paid or accrued to Samoa. You should figure that credit on Form 1116, and attach that form to the U.S. tax return, Form 1040. Show your wages paid for services performed in Samoa on Form 1116 as income from sources in a possession.

Illustrated Example

This example, illustrated on the filled-in Form 4563, shows how John Black figured his 1980 gross taxable income. It also shows that he qualified for the possession exemption for that year.

1) John, a bachelor, was employed in American Samoa by the Samoa Products Co., a private Samoan corporation, from April 3, 1973, through October 15, 1980. His applicable period is entered in columns (b) and (c) of Form 4563. Since an applicable period for the 80% and 50% tests is never more than the 3-year period immediately before the end of the tax year involved, the applicable period for his 1980 tax year is from January 1, 1978, through October 15, 1980.

2) His wages earned during the applicable period are listed here. All these amounts were received in Samoa and are payments for services there. Since these wages were from Samoan sources, they are entered in column (d). He worked in the United States from November 3, 1980, to December 31, 1980, and earned $1,200 during that period.

Samoan Wages	
1/1/78 to 12/31/78	$8,000
1/1/79 to 12/31/79	9,000
1/1/80 to 10/15/80	14,800

3) He received dividends from Samoan corporations during the applicable period, as listed here. All these amounts were actually received in Samoa. The corporations did business only in Samoa. The figures are entered in column (e).

Dividends from Samoan Corporations	
1/1/78 to 12/31/78	$100
1/1/79 to 12/31/79	160
1/1/80 to 10/15/80	220

4) He received dividends in the United States during the applicable period from several Canadian and United Kingdom corporations that carry on business mainly in those countries. Note that these dividends were from sources outside both the United States and possessions. Gross income from foreign sources is entered in column (f).

It is especially important to know that these foreign dividends were received directly by his bank in the United States. Because they were received in the United States, they must be treated as taxable income, but this does not change the fact that they were from foreign sources and should be entered in column (f).

Dividends from Corporations of Foreign Countries	
1/1/78 to 12/31/78	$600
1/1/79 to 12/31/79	800
1/1/80 to 10/15/80	800

5) He received dividends from a number of large U.S. corporations that do business mainly in the United States. These dividends were from U.S. sources and must be treated as taxable income regardless of where they were received. The figures are entered in column (g).

Dividends from U.S. Corporations	
1/1/78 to 12/31/78	$1,600
1/1/79 to 12/31/79	2,000
1/1/80 to 10/15/80	1,800

6) Now he should determine whether he qualifies for the possession exemption.

80% Rule

Gross income from possession sources (line 5), $32,280 ÷ Total gross income (line 7), $39,880 = 80.9%

50% Rule

Gross income from possession wages (column (d) line 4), $31,800 ÷ Total gross income (line 7), $39,880 = 79.7%

Since both the 80% and 50% rules have been satisfied, John qualifies for the possession exemption.

7) Now that John knows he qualifies for the possession exemption in 1980, he must decide which items of 1980 income are taxable and which are exempt.

   a) His 1980 wages of $14,800 shown in column (d) are exempt, because they were from possession sources and were not received in the United States. The $1,200 wages he earned in the United States during 1980 were income from U.S. sources and taxable without regard to the place where they were received.

   b) His 1980 dividends of $220 (column (e)) received from Samoan corporations are exempt from tax, because they were from possession sources and were not received in the United States.

   c) His 1980 dividends of $800 (column (f)) from sources in Canada and the U.K. are taxable, because they were received in the United States. Had these dividends been received during his applicable period outside the United States, they would have been exempt.

   d) His 1980 dividends of $1,800 (column (g)) from U.S. sources are taxable. U.S. source income is taxable without regard to the place where it was received.

If you qualify for the possession exemption, it is suggested that you attach a statement to your return giving the information described in paragraphs 6 and 7 of this example. In other words, show that you meet both the 80% and 50% tests and explain why you consider some of your income taxable and other income exempt. Also, report the taxable income in the appropriate parts of Form 1040, such as wages in the section for wages and dividends in the section for dividends.

Form **4563**
Department of the Treasury
Internal Revenue Service

Exclusion of Income from Sources in United States Possessions

▶ See separate instructions.
▶ Attach to Form 1040.

1980

Name(s) as shown on Form 1040: John Black

Your social security number: 023 45 6789

Year	Name of possession
1978	American Samoa
1979	American Samoa
1980	American Samoa

Total Gross Income and Possessions Exclusion
(See Instructions A and B)

Year (a)	Periods when you received income from sources in U.S. possessions (Dates are inclusive) From— (b)	To— (c)	Gross income during periods shown in columns (b) and (c): From sources in U.S. possessions — From salary, wages, or active conduct of a trade or business (d)	Other income (e)	From sources outside U.S. and U.S. possessions (f)	From sources within U.S. (g)
1 1978	1-1	12-31	$ 8,000	$ 100	$ 600	$ 1,600
2 1979	1-1	12-31	9,000	160	800	2,000
3 1980	1-1	10-15	14,800	220	800	1,800
4 Totals			$ 31,800	$ 480	$ 2,200	$ 5,400

5 Income from sources in U.S. possessions. Add columns (d) and (e), line 4	$ 32,280
6 Income from sources other than U.S. possessions. Add columns (f) and (g), line 4	$ 7,600
7 Total gross income for test period. Add lines 5 and 6. (See instruction A to determine if you qualify for the exclusion.)	$ 39,880

Source of Gross Income from Salary, Wages, or Active Conduct of a Trade or Business
(Column (d) above)

Year	Name and address of employer (if self-employed, write Self-employed)	Kind of business
1978	Samoa Products Co., 30 Corpa Ave., Pago Pago, Samoa	Retail Merchandising
1979	"	"
1980	"	"

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